Form
Unknown document format

el Channel and travelchannel.com, which was valued at $575 million, resulted in a $135 million tax-free gain included in DCH s continuing operations. The ownership interest previously owned by Cox was retired. Upon completion of the Cox Transaction, DHC held a 66 2/3% interest in DCH and Advance/Newhouse held a 33 1/3% interest in DCH.

The Cox Transaction resulted in no change in DHC s total investment in DCH. However, DHC s share of DCH s recorded net assets was reduced, creating approximately $533 million in excess basis. The allocation process was completed in the first quarter of 2008 and resulted in approximately 48% of the excess basis created by the Cox Transaction being allocated to content and intangible assets with determinable useful lives. Additional information regarding the content and intangible assets is presented in Note 7.

From January 1, 2007 through May 14, 2007, DHC recorded its 50% share in the earnings of DCH. From May 15, 2007 to September 17, 2008, DHC recorded its 66 2/3% share in the earnings of DCH. As mentioned above, the financial results of both DHC and DCH are presented on a combined basis in Discovery s financial statements as of January 1, 2008. Therefore, DHC s 2008 financial results have been recast to report DCH on a combined basis rather than under the equity method. The presentation of the 2007 consolidated financial statements includes the results of DCH s operations as an equity method investment for the period prior to January 1, 2008 as equity in earnings of DCH. The interest in DCH owned by Advance/Newhouse for the period January 1, 2008 to September 17, 2008 is reflected as minority interest in consolidated subsidiaries, net of tax.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

DHC s carrying value for DCH was $3.3 billion at December 31, 2007. In addition, enterprise-level goodwill of $1.8 billion was allocated to the investment in DCH.

Summarized financial information for DCH is as follows:

Consolidated Balance Sheet

		December 31, 2007 (amounts in millions)
Cash and cash equivalents	$	45
Other current assets		1,032
Property and equipment, net		397
Goodwill and intangible assets		5,052
Noncurrent content rights, net		1,048
Other assets		386
Total assets	$	7,960
Current liabilities	$	1,093
Long-term debt		3,866
Other liabilities		244
Redeemable interests in subsidiaries		49
Members equity		2,708
Total liabilities, redeemable interests in subsidiaries, and members equity	$	7,960

Consolidated Statement of Operations

		Nine Months Ended September 30, 2007 (amounts in millions)
Revenues	$	2,241
Cost of revenues		(736)
Selling, general and administrative		(949)
Exit and restructuring costs		(16)
Depreciation and amortization		(95)
Asset impairments		(26)
Gain from disposition of business		135
Operating income		554
Equity in earnings of unconsolidated affiliates		6
Interest expense, net		(179)
Other, net		2

Provision for income taxes		(74)
Minority interests in consolidated subsidiaries, net of tax		(2)
Net income from continuing operations		307
Net loss from discontinued operations		(61)
Net income	$	246
DHC s share of DCH s net income	$	158

The Oprah Winfrey Network

On June 19, 2008, Discovery entered into a 50%-50% joint venture with Oprah Winfrey and Harpo, Inc. (Harpo) to rebrand Discovery Health Channel as OWN: The Oprah Winfrey Network (OWN Network). It is expected that Discovery Health will be rebranded as the OWN Network in late 2009.

Pursuant to the agreement, Discovery has committed to fund up to $100 million of the venture s operations through September 2011. To the extent funding the joint venture in excess of $100 million is necessary, the Company may provide additional funds through a member loan or require the venture to seek third party financing. Discovery must contribute its interest in the Discovery Health Channel and certain DiscoveryHealth.com content. Harpo must contribute the Oprah.com website (which will serve as the platform for the venture website) and certain Oprah.com content.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Discovery and Harpo must make these contributions on the launch date unless it is mutually agreed that certain contributions will be made prior to the launch date for the benefit of the venture.

In connection with the formation of the OWN joint venture, Discovery provided a put right to Harpo which is exercisable on four separate put exercise dates within 12.5 years of the Venture s formation date. The put arrangement provides Harpo with the right to require Discovery to purchase its 50 percent ownership interest at fair market value up to a maximum put amount. The maximum put amount ranges between $100 million on the first put exercise date up to $400 million on the fourth put exercise date.

Through September 30, 2008, no significant contributions have been made to the venture. Voting control of the venture is shared by Harpo and the Company, but the Company has determined that this entity qualifies as a variable interest entity and has consolidated the venture as its primary beneficiary. As Harpo has not yet contributed any assets to the venture, the Company is recording 100% of the losses. During the three and nine months ended September 30, 2008, the Company incurred transaction costs of $4 million and $7 million, respectively, related to the OWN joint venture.

4. DISPOSITIONS

Ascent Media Corporation Spin-off

On September 17, 2008, as part of the Newhouse Transaction (Note 1), DHC completed the spin-off to its shareholders of AMC, a subsidiary holding the cash and businesses of DHC, except for certain businesses that provide sound, music, mixing, sound effects and other related services under brand names such as Sound One, POP Sound, Soundelux and Todd A-O (which businesses remained with the Company following the completion of the Newhouse Transaction). The AMC spin-off was structured as a tax free transaction and there was no gain or loss related to the spin-off. As there is no continuing involvement in the operations of AMC, the financial results of AMC have been presented as discontinued operations in the consolidated financial statements in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144) for all periods presented.

Palm Bay Disposition

On September 8, 2008, DHC sold its ownership interests in Palm Bay for approximately $7 million in cash. It was determined that Palm Bay was a non-core asset, and the sale of Palm Bay was consistent with DHC s strategy to divest non-core assets. DHC recognized a pre-tax gain of approximately $3 million in connection with the sale of Palm Bay, which is recorded as a component of net income from discontinued operations. As there is no continuing involvement in the operations of Palm Bay, the financial results of Palm Bay have been presented as discontinued operations in the consolidated financial statements in accordance with FAS 144 for all periods presented.

Ascent Media CANS, LLC Disposition

On September 4, 2008, DHC sold its ownership interests in Ascent Media CANS, LLC (DBA AccentHealth) for approximately $119 million in cash. It was determined that AccentHealth was a non-core asset, and the sale of AccentHealth was consistent with DHC s strategy to divest non-core assets. DHC recognized a pre-tax gain of approximately $64 million in connection with the sale of AccentHealth, which is recorded as a component of net income from discontinued operations. As there is no continuing involvement in the operations of AccentHealth, the financial results of AccentHealth have been presented as discontinued operations in the consolidated financial statements in accordance with FAS 144 for all periods presented.

Asset Dispositions

During the three and nine months ended September 30, 2008, DHC disposed of certain buildings and equipment for approximately $13 million in cash. DHC recognized a pre-tax gain of approximately $9 million in connection with the asset disposals. The disposed assets were part of the AMC business. Accordingly, the gain is recorded as a component of net income from discontinued operations.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Summary of Discontinued Operations

Summary financial data for the discontinued operations related to the above transactions for the three and nine months ended September 30, 2008 and 2007 is as follows:

Income Statement:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(amounts in millions)			
Revenues	$ 134	$ 163	$ 482	$ 470
(Loss) income from the operations of discontinued operations before income taxes	$ (8)	$ 5	$ (6)	$ 6
Net (loss) income from the operations of discontinued operations	$ (7)	$ 5	$ (5)	$ 4
Gains on dispositions, net of tax	$ 47	$	$ 47	$
Net income per share from discontinued operations, basic and diluted	$ 0.13	$ 0.02	$ 0.15	$ 0.01
Average shares outstanding, basic and diluted	302	280	287	280

Balance Sheet:

	December 31, 2007 (amounts in millions)
Current assets	$ 352
Total assets	$ 786
Current liabilities	$ 112
Total liabilities	$ 135

No interest expense was allocated to discontinued operations for the periods presented herein since there was no debt specifically attributable to discontinued operations or that was required to be repaid following the spin-off.

5. FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Company adopted FAS 157 for all financial instruments accounted for at fair value on a recurring basis. In accordance with FAS 157, a fair value measurement is determined based on the assumptions that a market participant would use in pricing an asset or liability. FAS 157 also established a three-tiered hierarchy that draws a distinction between market participant assumptions based on (i) observable inputs such as quoted prices in active markets (Level 1), (ii) inputs other than quoted prices in active markets that are observable either directly or indirectly (Level 2), and (iii) unobservable inputs that require the Company to use present value and other valuation techniques in the determination of fair value (Level 3). The following table presents information about assets and liabilities required to be carried at fair value on a recurring basis as of September 30, 2008:

	Fair Value Measurements as of September 30, 2008 Using: (amounts in millions)		
		Significant	
	Quoted		
	Market	Other	Significant

	Fair Value as of September 30, 2008	Prices in Active Markets for (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets				
Available for sale securities	$ 15	$ 15	$	$
Deferred compensation plan assets	37	37		
Liabilities				
Derivatives	(51)		(51)	
Deferred compensation plan liability	(37)		(37)	
HSW International, Inc. liability	(35)			(35)
Redeemable interests in subsidiaries	(49)			(49)
	$ (120)	$ 52	$ (88)	$ (84)

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

For assets that are measured using quoted prices in active markets, the total fair value is the published market price per unit multiplied by the number of units held without consideration of transaction costs. Assets and liabilities that are measured using significant other observable inputs are primarily valued by reference to quoted prices of similar assets or liabilities in active markets, adjusted for any terms specific to that asset or liability.

In December 2007, Discovery acquired HowStuffWorks.com (HSW) and a 49.5% interest in HSW International, Inc. (HSWi). Pursuant to the terms of the agreement, Discovery has the option to: (i) distribute the HSWi stock to the former HSW shareholders, or (ii) sell the HSWi stock and distribute substantially all of the proceeds to former HSW shareholders. Discovery recognized a liability for its estimated obligation with respect to the HSWi shares to the former HSW shareholders. HSWi shares are publicly traded on the Nasdaq Global Market. Based upon the volatility and thinly traded nature of HSWi s stock, the Company does not believe the quoted market value of the underlying stock is indicative of fair value of the liability. The value of the HSWi liability is determined based on a discounted cash flow model using management s best judgments with respect to discount rates and terminal values. Discovery adjusts the liability each period to fair value through adjustments to earnings. The valuation considers forecasted operating results and market valuation factors. The estimated liability at September 30, 2008 is $35 million. As of September 30, 2008, Discovery s ownership interest in HSWi has been diluted to 42.8% as a result of HSWi issuing additional equity capital.

The Company estimates the redeemable interests in subsidiaries based on a contractual formula considering the projected results of applicable networks. Refer to Note 9 for further discussion.

The following table reconciles the beginning and ending balances of liabilities classified as Level 3 measurements and identifies the net income the Company recognized during the three months ended September 30, 2008:

	HSWi Liability	Redeemable Interests in Subsidiaries
	(amounts in millions)	
Balance as of July 1, 2008	$ (43)	$ (49)
Total gains:		
Included in net income	8	
Included in other comprehensive income		
Purchases, issuances, settlements, net		
Transfers in and/or out of Level 3		
Balance as of September 30, 2008	$ (35)	$ (49)

The following table reconciles the beginning and ending balances of liabilities classified as Level 3 measurements and identifies the net income the Company recognized during the nine months ended September 30, 2008:

	HSWi Liability	Redeemable Interests in Subsidiaries
	(amounts in millions)	
Balance as of January 1, 2008	$ (54)	$ (49)
Total gains:		
Included in net income	19	

Included in other comprehensive income				
Purchases, issuances, settlements, net				
Transfers in and/or out of Level 3				
Balance as of September 30, 2008	$	(35)	$	(49)

Total gains of $8 million and $19 million for the three and nine months ended September 30, 2008 were recorded in other, net.

During the three and nine months ended September 30, 2008, the Company recorded other-than-temporary impairment charges of $8 million and $16 million, respectively, related to its investment in HSWi, which were recorded in other, net.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

6. CONTENT RIGHTS

Content rights consisted of the following (no such amounts were recorded by DHC at December 31, 2007):

	September 30, 2008 (amounts in millions)
Produced content rights	
Completed	$ 1,401
In-process	251
Co-produced content rights	
Completed	429
In-process	91
Licensed content rights	
Completed	213
In-process	25
Content rights, at cost	2,410
Accumulated amortization	(1,182)
Content rights, net	1,228
Less: current portion	79
Non current portion	$ 1,149

Amortization of content rights is recorded as a component of cost of revenue and was $178 million and $495 million for the three and nine months ended September 30, 2008, respectively. Amortization for the three months ended September 30, 2008 includes an impairment charge of approximately $21 million for completed content and a write-off of $4 million in content that was in development. Amortization for the nine months ended September 30, 2008 includes an impairment charge of approximately $26 million for completed content and a write-off of $14 million in content that was in development. The impairment and write-off in 2008 were the result of new programming leadership evaluating the networks programming portfolio assets and concluding that certain programming no longer fit the strategy of the networks and would no longer be aired.

7. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets consisted of the following:

	September 30, 2008	December 31, 2007
	(amounts in millions)	
Goodwill	$ 7,096	$ 1,782

Trademarks, net of accumulated amortization of $10 million and zero	$ 55	$ 1
Customer lists, net of accumulated amortization of $120 million and zero	302	
Other, net of accumulated amortization of $92 million and zero	35	
Intangible assets, net	$ 392	$ 1

13

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Changes in the net carrying amount of goodwill were as follows:

	Reconciliation of net carrying amount of goodwill (amounts in millions)	
Balance as of December 31, 2007	$	1,782
Newhouse Transaction		4,870
DHC equity investment goodwill		475
HSW purchase accounting adjustment		(23)
Translation and other		(8)
Balance as of September 30, 2008	$	7,096

U.S. networks, international networks, and commerce, education, and other have $5.9 billion, $1.1 billion, and $44 million of allocated goodwill, respectively. The allocation of goodwill following the Newhouse Transaction was based on a preliminary assessment, which will be finalized prior to December 31, 2008.

Discontinued Operations

The December 31, 2007 goodwill balance excludes $127 million of AMC goodwill, which has been reclassified to assets of discontinued operations.

DHC Equity Investment Goodwill

As a result of the Cox Transaction (described in Note 3) on May 14, 2007, DHC s ownership percentage of Discovery increased from 50% to 66 2/3%. The repurchase of Cox s interest in Discovery created a basis differential between DHC s and Advance/Newhouse s investment balances and their share of the net assets of Discovery. DHC and Advance/Newhouse allocated the gross basis differential to Discovery in the first quarter of 2008 assets as follows:

	Allocation (amounts in millions)		Useful life
Content	$	46	14
Customer relationships	$	278	8
Goodwill	$	475	Indefinite
Total	$	799	

As a result of the Newhouse Transaction, the basis differential has been reclassified from the equity investment line to the respective assets on the Company s balance sheet. Amortization expense for these assets is $9 million and $27 million for the three and nine months ended September 30, 2008, respectively, of which additional basis in content of $1 million and $2 million was recorded in cost of revenues during the three and nine months ended September 30, 2008, respectively. During 2008, the reclassification of the basis differential is the only significant change to the Company s intangible assets.

HSW Purchase Accounting Adjustment

During the quarter ended September 30, 2008, the Company adjusted the deferred tax liabilities associated with HSW following an assessment of acquired net operating loss carry forwards that would be realizable, resulting in a $23 million reduction of goodwill.

Recoverability of Goodwill

The Company annually assesses the carrying value of goodwill to determine whether impairment may exist, unless indicators of impairment become evident requiring immediate assessment. The Company s annual impairment testing is performed in the fourth quarter. As of September 30, 2008, and continuing into the fourth quarter, the Company s market capitalization declined compared with December 31, 2007, as a result of unusual capital market volatility. The Company does not believe that a triggering event has occurred during 2008, as much of this decline has taken place recently and has not existed for an extended period of time.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

The Company will perform its annual goodwill impairment assessment in the fourth quarter of 2008 and will consider the impact of this decline in market capitalization if it continues.

The determination of recoverability of goodwill requires significant judgment and estimates regarding future cash flows, fair values, and the appropriate grouping of assets. Such estimates are subject to change and could result in impairment losses being recognized in the future.

8. DEBT

Debt at September 30, 2008, consists of the following (no debt was outstanding for DHC at December 31, 2007):

		September 30, 2008 (amounts in millions)
$1.0 billion Term Loan A, due quarterly December 2008 to October 2010	$	1,000
$1.6 billion Revolving Loan, due October 2010		340
260 million Revolving Loan, due April 2009		11
$1.5 billion Term Loan B, due quarterly September 2007 to May 2014		1,481
7.45% Senior Notes, semi-annual interest, due September 2009		55
8.37% Senior Notes, semi-annual interest, due March 2011		220
8.13% Senior Notes, semi-annual interest, due September 2012		235
Floating Rate Senior Notes, semi-annual interest, due December 2012		90
6.01% Senior Notes, semi-annual interest, due December 2015		390
Obligations under capital leases		81
Other notes payable		1
Subtotal		3,904
Less: current portion		(349)
Total long-term debt	$	3,555

During the first nine months of 2008, the Company paid $80 million under its revolving loans and paid off $200 million in long-term debt. Future principal payments under the debt arrangements, excluding obligations under capital leases and other notes payable, as of September 30, 2008, are as follows: $66 million during the fourth quarter of 2008, $456 million in 2009, $917 million in 2010, $235 million in 2011, $340 million in 2012, $15 million in 2013, and $1.8 billion thereafter.

9. REDEEMABLE INTEREST IN SUBSIDIARIES

People & Arts Latin America and Animal Planet Channel Group

Discovery and the British Broadcasting Corporation (the BBC) have formed several cable and satellite television network joint ventures to develop and distribute programming content. Generally, the ventures are 50%-50% owned by Discovery and the BBC. In addition to its own funding requirements, Discovery has assumed the BBC funding requirements, giving Discovery preferential cash distribution with these ventures. Discovery controls these ventures and consolidates them accordingly.

Pursuant to the terms of the venture agreements, the BBC has the right, but not the obligation, to require Discovery to purchase the BBC s interest for cash if the People & Arts Latin America or the Animal Planet Channel Group (comprised of Animal Planet Europe, Animal Planet Asia, and Animal Planet Latin America) do not achieve certain financial performance benchmarks. A range for the estimated redemption value is based on a contractual formula

considering the projected results of each network within the channel group that is measured every three years commencing on December 31, 2002. Discovery has accreted to an estimated redemption value of $49 million as of September 30, 2008, which is management s best estimate within the range, based on certain assumptions and legal interpretations for the contractual formula. Changes in contractual interpretations and assumptions used to estimate the redemption value could materially impact current estimates. Discovery recorded no accretion to the redemption value during the nine months ended September 30, 2008.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

10. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted average number of common shares and preferred shares outstanding during the period. Preferred shares are included in the weighted average number of shares outstanding when calculating both basic and diluted income per share as the common shares and preferred shares participate equally in any dividends paid.

The weighted average number of shares oustanding for 2008 includes Discovery s common shares outstanding since January 1, 2008, which assumes the Newhouse Transaction was consummated January 1, 2008, and preferred shares outstanding since September 17, 2008, the date this new class of shares was issued. The weighted average number of shares outstanding for the three and nine months ended September 30, 2008 is 302 million and 287 million, respectively, which includes Series A, B, and C common shares, as well as Series A and C convertible preferred shares. The weighted average number of shares oustanding for 2007 represents DHC s common shares outstanding. The weighted average number of shares outstanding for the three and nine months ended September 30, 2007 is 280 million.

Diluted net income per share adjusts basic net income per share for the dilutive effects of convertible securities, stock options, and other potentially dilutive financial instruments, as if they had been converted at the beginning of the periods presented. Due to the relative insignificance of the dilutive securities in 2008 and 2007, their inclusion does not impact the basic net income per share amount as reported in the accompanying consolidated statements of operations.

11. STOCKHOLDERS EQUITY

Common Stock

In connection with the Newhouse Transaction, on September 17, 2008, the date the transaction was consummated, the existing shareholders of DHC received shares of Discovery s common stock. DHC Series A common stockholders and DHC Series B common stockholders received 0.50 shares of the same series of Discovery common stock and 0.50 shares of Discovery Series C common stock. As a result of this transaction, Discovery issued 134 million, 7 million, and 141 million shares of its Series A common stock, Series B common stock, and Series C common stock, respectively.

All three series of Discovery common stock (Series A, B and C) have the same rights and preferences, except: (i) the Series B common stock is convertible into the Series A common stock, and (ii) the Series B common stock has 10 votes per share, the Series A common stock has one vote per share, and the Series C common stock does not have any voting rights except as required by Delaware law.

Subject to any preferential rights of any outstanding series of Discovery s preferred stock created by Discovery s board from time to time, the holders of Discovery s common stock are entitled to such dividends as may be declared from time to time by Discovery s board from available funds. Generally, when a dividend is paid to the holders of one series of common stock, Discovery will also pay to the holders of the other series of common stock an equal per share dividend.

In the event of Discovery s liquidation, dissolution, or winding up, after payment or provision for payment of Discovery s debts and liabilities and subject to the prior payment in full of any preferential amounts to which Discovery s preferred stock holders may be entitled including the liquidation preference granted to holders of Series A convertible preferred stock and Series C convertible preferred stock, the holders of Series A common stock, Series B common stock, Series C common stock, Series A convertible preferred stock and Series C convertible preferred stock will share equally, on a share for share basis (and in case of holders of Series A convertible preferred stock and Series C convertible preferred stock, on an as converted into common stock basis), in Discovery s assets remaining for distribution to the holders of Discovery s common stock.

Preferred Stock

In connection with the Newhouse Transaction, on September 17, 2008, the date the transaction was consummated, Advance/Newhouse received shares of Discovery s Series A convertible preferred stock and Series C convertible

preferred stock. As a result of this transaction, Discovery issued 70 million of each of its Series A convertible preferred stock and Series C convertible preferred stock.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Both series of Discovery preferred stock (Series A and C) are convertible at any time into Discovery common stock initially representing 33 1/3% of the outstanding shares of Discovery common stock and 26% of the aggregate voting power of Discovery (other than with respect to the election of directors and select matters) based upon the number of shares of common stock issued in connection with the Newhouse Transaction. The Series A convertible preferred stock is convertible into a number of shares of Discovery Series A common stock equal to 50% of the aggregate number of shares of Discovery Series A and Series B common stock issued in the Newhouse Transaction, and the Series C convertible preferred stock is convertible into a number of shares of Discovery Series C common stock equal to 50% of the shares of Discovery Series C common stock issued in the Newhouse Transaction, in each case subject to anti-dilution adjustments. Advance/Newhouse is entitled to additional shares of the same series of convertible preferred stock if the stock options and stock appreciation rights outstanding immediately after the Newhouse Transaction are exercised into Discovery common stock. In order to satisfy this anti-dilution provision, the Company has placed approximately 536,000 shares of preferred stock into an escrow account upon the closing of the Newhouse Transaction for the benefit of Advance/Newhouse. The preferred shares will be released from escrow upon the exercise of the stock options or stock appreciation rights. The 536,000 preferred shares were issued and escrowed to avoid dilution to Advance/Newhouse as a result of the conversion of DHC equity awards outstanding immediately after the Newhouse Transaction. As described in Note 12, approximately 2 million of DHC options could not be immediately converted into Discovery options. Upon converting those options, the Company will be required to place approximately 1 million additional preferred shares into escrow.

The Discovery preferred stock has a right to vote with holders of common stock on an as-converted to common stock basis, voting together as a single class on all matters submitted for vote to the common stockholders of Discovery, except for the election of directors. The Discovery preferred stock has the right to elect three directors (preferred stock directors), and has special voting rights on select matters for so long as Advance/Newhouse or its permitted transferee owns at least 80% of the shares of Series A convertible preferred stock outstanding immediately following the closing of the Newhouse Transaction, including fundamental changes in the business of Discovery, mergers and business combinations, certain acquisitions and dispositions and future issuances of Discovery capital stock.

Subject to the prior preferences and other rights of any senior stock, whenever a cash dividend is paid to the holders of Discovery common stock, Discovery will also pay to the holders of the Series A convertible preferred stock and Series C convertible preferred stock an equal per share cash dividend on an as converted to common stock basis.

In the event of Discovery s liquidation, dissolution and winding up, after payment or provision for payment of Discovery s debts and liabilities and subject to the prior payment with respect to any stock ranking senior to Series A convertible preferred stock or Series C convertible preferred stock, the holders of Series A convertible preferred stock and Series C convertible preferred stock will receive, before any payment or distribution is made to the holders of any common stock or other junior stock, an amount (in cash or property) equal to $.01 per share. Following payment of such amount and the payment in full of all amounts owing to the holders of securities ranking senior to Discovery s common stock, holders of Series A convertible preferred stock and Series C convertible preferred stock will be entitled to share ratably, on an as-converted to common stock basis, with the holders of Discovery s common stock, as to any amounts remaining for distribution to such holders.

12. SHARE-BASED COMPENSATION

The Company has various active equity plans under which it is authorized to grant equity awards to employees including the Discovery Holding Company 2005 Incentive Plan and the Discovery Holding Company 2005 Non-Employee Director Plan (collectively the Incentive Plans). On September 17, 2008, Discovery assumed the Discovery Holding Company Transactional Stock Adjustment Plan and converted the awards under this plan, but the Company has no ability to issue new awards under this plan. Share based grants under the Incentive Plans may consist of non-qualified stock options, stock appreciation rights (SAR), restricted shares, stock units, cash awards, performance awards or any combination of the foregoing. The Discovery Appreciation Plan (DAP or LTIP) is a

long-term incentive plan under which qualifying employees are granted stock appreciation rights. Consistent with the application of ARB 51, all share-based compensation activity is presented on an as-converted basis as if the Newhouse Transaction had occurred on January 1, 2008. The Company also has a long term incentive plan associated with its acquisition of HSWi for the benefit of the subsidiary s employees (HSWi Plan). The HSWi plan is cash settled and is determined based on the share price of HSWi. No new grants will be made out of the plan, which is expected to terminate in 2010. Compensation expense related to the HSWi plan is $2 million and $7 million for the three and nine months ended September 30, 2008, respectively.

Incentive Plans

Options are granted with exercise prices equal to, or in excess of, the fair market value at the date of grant. Generally, the stock options vest 25% per year over a four-year vesting period beginning one year after the grant date and expire seven to ten years from the date of grant. Certain stock option awards provide for accelerated vesting upon an election to retire pursuant to the Company s incentive plans or after reaching a specified age and years of service.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Prior to September 17, 2008 (the date of the Newhouse Transaction), certain non-employee directors were granted stock options to acquire DHC stock. As of September 18, 2008, the stock options were converted pursuant to the merger agreement into options to acquire Discovery common stock. The conversion was based on the volume weighted average price of DHC s common stock for the last five trading days prior to September 17, 2008 and Discovery s common stock for the first ten trading days including and subsequent to September 17, 2008. As of September 30, 2008, the directors held approximately 2 million options to purchase the Company s common stock. As of September 30, 2008, approximately 2 million director s options could not be converted due to lack of share trading activity in Ascent Media Corporation Series B common stock. These options are presented in the table below at pre-conversion amounts.

During 2008, the Company issued one million stock options under the Incentive Plans. These options vest 25% per year, beginning one year after the grant date, and expire after seven years. Included in this issuance were 500,000 options issued to a non-employee of the Company, which did not include a substantive performance requirement. This resulted in the immediate recognition of $3 million of cost in the three and nine months ended September 30, 2008.

The fair value of each stock option issued under the Incentive Plans is determined using the Black-Scholes option-pricing model, using factors set forth in the table below. Risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term, which represents the period of time that options granted are expected to be outstanding, is estimated based on the simplified method as allowed by Staff Accounting Bulletin No. 107, *Share-Based Payment* (SAB 107). The simplified method allows companies who issue plain-vanilla options to estimate the option term without analyzing historical data. The volatility assumption considers both historical volatility and implied volatility which may be impacted by the Company s performance as well as changes in economic and market conditions. Dividend yield is assumed to be 0%, because the Company does not expect to pay dividends in the future. The assumptions used in this option-pricing model were as follows:

	Nine Months Ended September 30,	
	2008	2007
Risk-free interest rate	2.83%	4.57%
Expected term (years)	6.10	5.50
Expected volatility	32.35%	25.50%
Dividend yield	0.00%	0.00%

A summary of option activity as of and for the nine months ended September 30, 2008, is presented below:

	Options (in millions)	Weighted Average Price
Outstanding at December 31, 2007	3.0	$ 16.49
Options granted	0.9	$ 13.81
Options exercised		$ 0.00
Options forfeited		$ 0.00
Outstanding at September 30, 2008	3.9	$ 15.86
Weighted average remaining contractual life for outstanding option awards at end of period (years)		5

At September 30, 2008, there was $2 million of unrecognized compensation cost related to unvested stock options, which the Company expects to recognize over a weighted average period of 4 years.

On October 1, 2008, the Company issued approximately 5.0 million cash settled SARS and 6.5 million stock options to employees. The SARS and stock options have a fair value of $3.39 per SAR and $6.22 per option, respectively and will be expensed over the requisite service period.

Long-Term Incentive Plan (Previously Referred to as Discovery Appreciation Plan)

These awards, which are cash-settled, consist of a number of units which represent an equivalent number of shares of Series A common stock of the Company and have a base price which is determined based on the Company s stock price. Each award vests as to 25% of the units on each of the four anniversaries of the date of grant. Upon voluntary termination of employment, the Company distributes 100% of vested unit benefits if employees agree to certain provisions.

Compensation expense associated with LTIP units is recorded as a component of selling, general and administrative expenses. The Company classifies the fair value of the vested units as a current liability.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

Prior to September 17, 2008 (the date of the Newhouse Transaction), the LTIP units were accounted for in accordance with FASB Statement No. 133, *Accounting for Derivative Financial Instruments* (FAS 133), and EITF Issue No. 02-8, *Accounting for Options Granted to Employees in Unrestricted, Publicly Traded Shares of an Unrelated Entity* (EITF 02-8), as the value of the units were indexed to the value of DHC Series A common stock. The Company accounted for the units similar to a derivative, by determining their fair value each reporting period and attributed compensation expense for the awards on a straight-line basis, based on the grant-date fair value and scheduled vesting of the share units. As of September 18, 2008, the LTIP units were converted at the effective time of the Newhouse Transaction to reflect the changes in DHC s stock and are now indexed to the share price of Discovery s common stock and subject to the provisions of FASB Statement No. 123(R), *Share-Based Payment* (FAS 123(R)), which requires the Company to estimate the number of shares that are not expected to vest due employee turnover. As a result of the conversion, there are approximately 31 million LTIP units outstanding. Application of the estimated forfeiture rate, which was not required by FAS 133, resulted in a decrease in the accrued compensation liability of $2 million.

In accordance with FAS 123(R), the fair value of each LTIP unit award is recalculated at the end of each reporting period and the liability and expense adjusted based on the new fair value. The assumptions used to determine the fair value of each LTIP unit at September 30, 2008, were as follows:

Risk-free interest rate	1.51%
Expected term (years)	1.03
Expected volatility	38.45%
Dividend yield	0.00%

A summary of LTIP unit activity as of and for the nine months ended September 30, 2008, is presented below:

	LTIP Units (in millions)	Weighted Average Price		Weighted Average Contractual Life	Aggregate Intrinsic Value (in millions)	
Outstanding at December 31, 2007	31.0	$	18.46			
Granted	5.1	$	25.11			
Exercised	(2.9)	$	18.89			
Forfeited	(1.9)	$	20.17			
Outstanding at September 30, 2008	31.3	$	18.80	1.03	$	73

Share-Based Compensation Expense

Compensation expense (benefit) and the related tax expense (benefit) recognized for share-based compensation plans for the three and nine months ended September 30, 2008 and 2007 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(amounts in millions)			
Stock options			1	2

Long-term incentive plan benefit	(65)	(48)	
Total impact on operating income	(65)	(47)	2
Tax expense recognized	23	17	

The Company made cash payments of $2 million and $20 million during the three and nine month periods ended September 30, 2008 related to the LTIP. The Company also made cash payments of $28 million during the fourth quarter for LTIP grants maturing in October 2008.

DISCOVERY COMMUNICATIONS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited) (continued)

13. EXIT AND RESTRUCTURING COSTS

Exit and restructuring costs expensed by segment for the three and nine months ended September 30, 2008 are as follows (no material exit and restructuring costs were recorded by DHC in 2007):

	Three Months Ended September 30,	Nine Months Ended September 30,